City of Lincoln Nebraska
Police and Fire Pension
Summary for 8/11/98 Advisory Committee Meeting

Members Present: Dennis Duckworth, Don Stading, Al McCray, Aaron Drake.
Members Absent: Jim George, Geoff Marti
City Staff: John Cripe, Paul Lutomski
Others: None

Dennis Duckworth: Meeting is called to order. What were the recent activities?

John Cripe: Page 1 of your packet is a memo to Mayor Johanns regarding changing from annual interest crediting to monthly interest crediting. The mayor has approved this and we will go forward with it if the committee has no objection to it. Employees will have to know interest rates will change monthly. When they get a pension estimate their estimated account values will change due to the monthly interest calculation. We will write all members a letter explaining this if the change is approved by the council. Committee members will probably get some questions concerning the change.

Don Stading: I make a motion to accept the change for purposes of discussion.

Aaron Drake: Second.

Don Stading: You are crediting interest retroactively annually and want to change to crediting retroactively monthly. What was the forecast issue?

John Cripe: We have a computer program that estimates pension benefits for any future date for any member. To estimate pension benefits we must forecast both salary and account values. Salary increases are set to default at 3%, but anywhere from 0% to 6% can be used as the employee wishes. Interest rate is not variable. It is either our 7% assumed rate, or the actual rate in arrears. To explain: For any given calendar year we know exactly what we will be crediting since the rate is credited in arrears. For example, in 1997 the pension earned 14.82%. This rate is credited to the members account balance as of January 1, 1998. So, if a member comes in today and wants an estimate for November 10, 1998 we apply the 14.82% against their 1/1/98 account balance and the estimate will match exactly with the interest shown if they really do retire on November 10, 1998. Beyond 1998 the system uses 7% as the interest rate. After the change to monthly crediting, the 7% will kick in for any estimates past the month for which we have calculated the return. This means the final interest figure, even in the same calendar year, will not match the estimated interest figure.

Don Stading: So if you were to add a disclosure to the estimate it would eliminate some confusion.

John Cripe: We have a disclosure now, we can modify it. We also have our assumptions on a cover sheet. This change will be a benefit to members because it more closely matches the return rate with the period the return was earned. Interest rates will look very good to begin with because we will credit the compounded rate, in other words 14.82% with whatever the pension assets have earned YTD, at the startup month.

Dennis Duckworth: Other Discussion? All in favor?

All: Aye.

Dennis Duckworth: Passes.

Paul Lutomski: The next step is to take this language and show it to the law department for approval, then the City Council for adoption. It should be done before year end. Item #2. There was a correction to base pay. On 6/25/98 Fire Captain Larry Rakow called with a pension estimate question. From his question I became aware of a mistake concerning pension base pay. To explain: During a meeting about the CIR back pay, it was thought some earnings codes were being included in pension base pay that should not have been included. Mr. Spadt agreed with City Administration: if incorrect codes were being used the correct codes should be used after the CIR back pay checks were finished. Past this statement, he had no further role, and definitely did not contribute to the base pay error.

Effective the 4-9-98, pay date earning codes #114 Personal Holiday, #112 Holiday Pay, #117 Mayor's Award of Excellence, #127 Wellness Payment were not included in pension base pay. Now code 114 and 112 are included again. Code # 112 Holiday Pay was excluded because it was incorrectly believed to be the double-time portion of holiday pay. We now know code 112 pays for the straight time portion and 151 for the double time portion of holiday pay. City management never intended the straight time portion of Holiday Pay be excluded from pension base pay.

I worked with John Cripe to arrange for the corrections. Originally I thought it would be easy to fix, but due to the complexities of the TESSERACT payroll system the problem was just fixed today.

Al McCray: We used to use TESSERACT, but we don't anymore.

John Cripe: It is a difficult system. Over the years the Finance Department had added some earnings code to pension base pay without authorization. During the CIR discussions we discovered this and had to remove them going forward, after the CIR back pay was done. We weren't given enough information by Finance to determine that holiday pay was broken into two pieces.

Paul Lutomski: Item "C." On page 3 there is a memo to move pension assets to a separate account at U.S. Bank. Currently pension assets are split between U.S. Bank and NBC. NBC already has a separate account for pension assets. The assets have been moved.

Item "D." Recently we requested a legal opinion from the City Attorney regarding three issues. The opinion was that 1) the pension must pay Central Services Costs.

Aaron Drake: Do they justify it?

Paul Lutomski: Yes. The memo starts on page 4. Basically the Finance Department has the right to choose which department's have to pay central services. Opinion 2) We asked if the Finance Department can set the tax levy for the pension, or rather can we set our own tax levy to get the funding we think is appropriate for the pension. The answer was the pension administration can't set the pension tax levy and only the finance department can set the levy. Opinion 3) stated the pension must rely on the Finance Department to issue checks and safekeep securities.

Our goal was to get away from the Finance department to operate the pension more independently. It appears that is not possible right now.

John Cripe: We'll keep trying. We're not having any trouble with Finance. It's just irritating we don't have control over these three areas.

Paul Lutomski: They did promise to double the city contribution to the pension for the next fiscal year. John have you heard anymore about that?

John Cripe: It was approved last night. Over the last year we have had extensive discussions with Finance about increasing the contribution. They now understand if the contribution is not gradually increased by a few hundred thousand every year for over the next few years, a drastic increase will be required eventually. The drastic increase would be in the millions of dollars. That got their attention. I think increasing the city contribution amount is our best accomplishment for the last four or five months.

Dennis Duckworth: How much is the new contribution?

John Cripe: About $800,000. Roughly twice the prior contribution. The plan was to increase by $200,000 annually up to $1.5 million, and then re-evaluate.

Al McCray: You've been trying to do that for a long time. Do the $200,000 increases need to pass a committee?

John Cripe: Yes. Every year the budget has to be passed by the Council. We'll remind finance and the council of the plan.

Paul Lutomski: Item "E" are transactions since the last meeting. On May 15, 1998 T-Notes matured and a CMO was purchase per committee motion. The CMO came reasonably close to the motion. Motion was for $2 million to be spent on a 5-7 year average life, priced at par, with monthly interest and GNMA collateral. We spent $2,025,093.75 priced 100.9296875 with 7.8 year AL. Please refer to pages 8-11 of your packet for more details. Page 9 shows we did not have much to choose from that met our criteria. Luckily two bonds looked good. I worked the brokers a little to get then to offer one bond at a two basis point higher spread than the other and then bought it.

The second transaction was June 19, 1998. A few days prior to the trade a broker called to offer $2,000,000 of a 30y/5y 6.75% TVA (Tennessee Valley Authority) coupon paid quarterly, priced at par. The coupon is locked for 5 years, then TVA can lower the coupon annually, but if we don't want to keep the bond we can sell it back to TVA at par. The coupon rate they reset to must be at least a 93 basis point spread above the existing 30 year Treasury bond no matter what the remaining life of the TVA bond.

The pension bought $2,000,000 of the TVA and sold Feb 2001 and May 2001 Treasury Notes for $2,136,542.95 to pay for it. The notes would have yielded about 5.5% annually until their maturity, so we swapped them for the 6.75% lock.
Please refer to pages 12 - 15 for detailed figures.

The third transaction was July 8, 1998. The pension sold $6.5 million of a monthly interest CMO and replaced it with two $3 million pieces of like security. To explain: We get a GRADE report from NBC each month. I noticed a CMO was expected to decline in value no matter if interest rates went up or down, so it was decided to sell it. It was a good bond for the pension yielding an annualized rate of 9.65% for the 1.25 years it was held. We sold it at it's highest point during our holding. We bought a $3,050,000 piece of GNMA collateral, unbroken PAC ban of 98-261, 10.3 AL 3 year window beginning 07 priced at 78 basis point spread to comparable AL treasury. GRADE was AC, coupon 6.25% price was 100.625. The second piece we bought was a $3,000,000 piece of GNMA collateral, unbroken PAC ban of 80-220, 11.1 AL, 4 year window beginning 07 priced at 98 basis point spread to comparable AL treasury. GRADE was BD, coupon 6.375% price was 100.21875.

Now on to the investment decision. Page 18 through 23 are the standard list of securities, and returns. All asset classes are doing well except for international equities. Our cash flow projection shows the pension could invest $2,000,000 on August 15th.

Please consider the following:

1. Cash Flow Estimate shown on pages 24-26 shows cash+repo is expected to reach a low of $2.5 million in October and a high of $3.5 million in June of 1999.
2. Maturity graph on page 27 shows values at the earlier of call date, principle begin pay date (for accrual tranche and interest paying CMOs), or maturity date.

Please note that:

- STRIPS are small in years 1998-2000 then start again in 2006 - 2019.
- FHLB strips purchased March '98 and July '97 have call dates in 1999 and 2001 respectively.
- Bonds are laddered from the year 2000 to 2007, with a spike in year 2003.
- CMOs are shown in white from 2005 - 2007 and in 2010 and 2011.

3. Page 28 is a balance sheet with EXHIBIT 1A showing the relationship between the pension's asset allocation and the allocation guidelines set forth in the Investment Policy. The pension owns all the CMOs and non-Treasury guaranteed securities allowed by the policy.
4. Page 29 shows a low yield curve.
5. Mayor Johanns has restricted further equity investments.
6. The City has doubled it's pension funding for next fiscal year and will slowly increase it thereafter. Therefore, for each of the next five years we estimate the pension is expected to have a net cash inflow surplus of about $1 million, even ignoring maturing funds.
7. The consensus of the financial community is an expectation toward lower interest rates. We have heard several expectations of 5% for the 30 year Treasury by the end of 1998. 1999 is expected to end even lower.
8. If approximately $2 million is invested now, the next time the pension will have funds to invest will be in September 1999 when we expect a FHLB strip to be called. The call amount will be $1.7 million, which may facilitate a $2 to $3 million investment at that time.
9. During periods of declining interest rates it makes financial sense to lock in a rate for the long term if possible.

Our recommendation …

Purchasing a CMO or non-Treasury security is eliminated because pension already owns the maximum allowed by the investment policy asset allocation guidelines.

Purchasing equities is eliminated because Mayor Johanns forbids it.

Purchasing a coupon paying bond is eliminated because of the surplus cash flow and the expectation of declining interest rates. Purchasing a coupon paying bond would mean even more surplus cash that would need to be re-invested at declining interest rates.

This leaves Treasury STRIPS or the Repo Pool..

Al McCray: This sounds like you are very limited in the types of securities you are able to buy. Could we also change the investment policy parameters to allow more flexibility.

Paul Lutomski: We could. I don't know if we are unhappy with the parameters.

John Cripe: I think if we do change the policy, it will have to be posted as an agenda item for a future meeting. A change like that would need a considerable amount of discussion. We would be glad to work with you if that's what the committee decides.

Paul Lutomski: Were you thinking corporate bonds?

Al McCray: I don't know what you were going to propose. It sound to me that you need more flexibility.

Paul Lutomski: We are proposing purchasing a 2017 maturity Treasury STRIP because it will fill in a gap in the pension's Treasury STRIP ladder and as market interest rates decline the 2017 STRIP's price will appreciate. A $2 million investment would mature to $6 million in 2017. In 1999 we would plan to invest $2 - 3 million in a 2005 maturity Treasury STRIP to even out the pension's maturity ladder.

Don Stading: I make a motion to buy the STRIP.

Al McCray: Second.

Dennis Duckworth: All in favor?

All: Aye.

Dennis Duckworth: Motion carries.

Don Stading: Russia halted trading on their stock market. Interest rates are headed downward. Are any of the pension's bonds in risk of being called early.

Paul Lutomski: Yes. The maturity graph in your packet shows the earlier of call or maturity date. We expect the call features of all our treasury and agency bonds to be utilized by their issuer. The CMO's get called by home owners pre-paying principle on their mortgages, or re-financing, so we don't have any way to know an exact call date for those, but we monitor them each month.

John Cripe: I think how the world is changing will impact the plan assets. It is always good to look at improving the investment policy to meet the demands of a changing investment environment, but since we don't have any money coming due for a long time we have plenty of time to update the policy.

Don Stading: I'd say you are all doing a good job.

Paul Lutomski: Any other questions or new business?

Dennis Duckworth: Meeting Adjourned.